INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	1
Statute and Regulations involved	2
Statement	3
Argument	4
Conclusion	11

CITATIONS

Cases:	
Bratton v. *Commissioner*, 217 F. 2d 486	5, 6, 7, 8
Brown v. *Commissioner*, 9 B. T. A. 965	5
Carroll-McCreary Co. v. *Commissioner*, 124 F. 2d 303	5
Chenango Textile Corp. v. *Commissioner*, 148 F. 2d 296	4
Commissioner v. *Auto Strop Safety Razor Co.*, 74 2d 226	5
Crean Bros. v. *Commissioner*, 195 F. 2d 257	5
First Nat. Bank & Trust Co. v. *United States*, 115 F. 2d 194	5, 6
Giblin v. *Commissioner*, decided October 29, 1954 (T. C.)	9
Giblin v. *Commissioner*, 227 F. 2d 692	8, 10
Helvering v. *Amer. Dental Co.*, 318 U. S. 322	5
Mallory, Estate of v. *Commissioner*, 27 B. T. A. 750	7
Olds v. *Commissioner*, 18 B. T. A. 1215	5, 8
United States v. *Oregon-Washington R. & Nav. Co.*, 251 Fed. 211	5
Statute:	
Internal Revenue Code of 1939, Sec. 23 (k) (26 U. S. C. 1952 ed., Sec. 23 (k))	2, 5
Miscellaneous:	
Treasury Regulations 45, Art. 51	4
Treasury Regulations 62, Art. 50	4

Miscellaneous—Continued

	Page
Treasury Regulations 65, Art. 49	4
Treasury Regulations 69, Art. 49	4
Treasury Regulations 74, Art. 64	4
Treasury Regulations 77, Art. 64	4
Treasury Regulations 86, Art. 22 (a)–14	4
Treasury Regulations 94, Art. 22 (a)–14	5
Treasury Regulations 101, Art. 22 (a)–14	5
Treasury Regulations 103, Sec. 19.22 (a)–14	15
Treasury Regulations 111, Sec. 29.22 (a)–13	2, 4
Treasury Regulations 118, Sec. 39.22 (a)–13	5

In the Supreme Court of the United States

OCTOBER TERM, 1955

No. 857

LIDGERWOOD MANUFACTURING CO., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (Pet. 17–26) are reported at 22 T. C. 1152. The opinion of the Court of Appeals (Pet. 11–15) is reported at 229 F. 2d 241.

JURISDICTION

The judgment of the Court of Appeals (Pet. 16) was entered on January 17, 1956. The petition for a writ of certiorari was filed on April 13, 1956. The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254.

QUESTION PRESENTED

Whether, as held by the courts below, the voluntary relinquishment by taxpayer, in 1946, of

any claim it had to the repayment of $650,000 advanced to its two wholly owned subsidiaries, in return for stock of the subsidiaries, constituted a contribution to the capital of the subsidiaries rather than a loss attributable to a worthless debt.

STATUTE AND REGULATIONS INVOLVED

Internal Revenue Code of 1939:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME.
>
> In computing net income there shall be allowed as deductions:
>
> * * * * *
>
> (k) [as amended by Sec. 113 of the Revenue Act of 1943, c. 63, 58 Stat. 21] *Bad Debts.*—
>
> (1) *General rule.*—Debts which become worthless within the taxable year; or (in the discretion of the Commissioner) a reasonable addition to a reserve for bad debts; and when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction. * * *
>
> * * * * *
>
> (26 U. S. C. 1952 ed., Sec. 23.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

> SEC. 29.22(a)–13. *Cancellation of Indebtedness.*—(*a*) *In general.*— * * * In general, if a shareholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction amounts to

a contribution to the capital of the corporation to the extent of the principal of the debt.

* * * * *

STATEMENT

The facts as found by the Tax Court (Pet. 18–23) were stated in abbreviated form by the Court of Appeals (Pet. 12–13) as follows:

In 1946, taxpayer, a New York corporation, had two wholly owned subsidiary corporations, Superior and Dutchess. On October 31, 1946, Superior owed its parent corporation some $411,000, and on that date the parent voluntarily cancelled $300,000 of the indebtedness, at the same time receiving 3,500 shares of Superior's common stock. On three occasions during 1946, taxpayer likewise cancelled debts owed to it by Dutchess and received in exchange shares of that debtor's common stock. Each of the debts, at the date when cancelled, was uncollectible. Appropriate entries on the books of the respective corporations were made to reflect a reduction in indebtedness of the subsidiaries and an increase in capital investment by the parent.

The purpose of the debt cancellations was to enable the subsidiaries to obtain needed bank loans. They did obtain such loans after the cancellations. They also obtained further advances from taxpayer, which were later repaid in full. (Pet. 13.)

The parent and both subsidiaries filed separate tax returns in 1946. Taxpayer's return, as originally filed, reported its net income, showed an increase during the year in the amount invested in its subsidiaries, and claimed no deduction for bad debts. Later, by amended returns, a bad debt deduction of $650,000 was claimed. (Pet. 13.)

On these facts, the Tax Court held that taxpayer made capital contributions to its subsidiaries and did not suffer a loss attributable to worthless debts. The Court of Appeals affirmed.

ARGUMENT

1. The decision below is correct and is in accord with the well-settled construction, evidenced both by governing Treasury Regulations and by a long line of judicial decisions, that, in general, where a stockholder[1] of a corporation, such as taxpayer herein, gratuitously forgives a debt due from the corporation (in this case the wholly-owned subsidiaries of the taxpayer corporation), the transaction constitutes a contribution to capital. Treasury Regulations 111, Section 29.22 (a)–13,[2] *supra*, pp. 2–3; *Chenango Textile Corp.* v.

[1] In this case, the stockholder is itself a corporation.

[2] Similar provisions have been included in all Treasury Regulations regulating income taxes since 1918. See Treasury Regulations 45, Art. 51 (1918); Treasury Regulations 62, Art. 50 (1921); Treasury Regulations 65, Art. 49 (1924); Treasury Regulations 69, Art. 49 (1926); Treasury Regulations 74, Art. 64 (1928); Treasury Regulations 77, Art. 64 (1932); Treasury Regulations 86, Art. 22(a)–14 (1934);

Commissioner, 148 F. 2d 296 (C. A. 2d); *Carroll-McCreary Co.* v. *Commissioner,* 124 F. 2d 303 (C. A. 2d); *Commissioner* v. *Auto Strop Safety Razor Co.,* 74 F. 2d 226 (C. A. 2d); *United States* v. *Oregon-Washington R. & Nav. Co.,* 251 Fed. 211 (C. A. 2d); *Crean Bros.* v. *Commissioner,* 195 F. 2d 257 (C. A. 3d); *Bratton* v. *Commissioner,* 217 F. 2d 486 (C. A. 6th); *Olds* v. *Commissioner,* 18 B. T. A. 1215; *Brown* v. *Commissioner,* 9 B. T. A. 965. See also *First Nat. Bank & Trust Co.* v. *United States,* 115 F. 2d 194, 196 (C. A. 5th). This principle was endorsed by this Court in *Helvering* v. *Amer. Dental Co.,* 318 U. S. 322, 328, which cited with approval the Regulations and the *Auto Strop* case.

Opposing this well-settled construction, taxpayer urges (1) that the language of Section 23 (k) (1) of the Internal Revenue Code of 1939, *supra,* p. 2, is "mandatory" and "absolute," and that once the fact of worthlessness of a debt is established a taxpayer must be accorded the deduction irrespective of other factors such as voluntary cancellation (Pet. 8); and (2) that the Regulations and decisions relied on by the Commissioner and the courts below are inapposite, although they deal with cancellations of

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Treasury Regulations 94, Art. 22(a)-14 (1936); Treasury Regulations 101, Art. 22(a)-14 (1938); Treasury Regulations 103, Sec. 19.22(a)-14, promulgated under the Internal Revenue Code of 1939; see, also, Treasury Regulations 118, Sec. 39.22(a)-13, promulgated under the Internal Revenue Code of 1939.

debts, because they describe the tax effects on the debtor corporation rather than the creditor stockholder.

The Court of Appeals considered and disposed of both these contentions. As to the first, it would seem clear, as stated by the Sixth Circuit in *Bratton* v. *Commissioner*, 217 F. 2d 486, 489, that loss from a worthless debt implies the existence of an obligation which cannot be collected, but that to the extent that the obligation itself is extinguished by the voluntary act of the taxpayer, so as to preclude any possibility of future payment, there remains no debt at all. See *First Nat. Bank & Trust Co.* v. *United States, supra.* The Second Circuit expressly disagreed with the contention of taxpayer that the cancellation was meaningless, stating (Pet. 14–15) that when a creditor cancels a debt in return for stock, he gives up the right to repayment, however prosperous the debtor may later become, and acquires a right to dividends from future prosperity. The court also pointed out that the cancellation here was a valuable contribution to the financial structure of the subsidiaries enabling them to obtain needed bank loans, to continue in business, and, subsequently, to prosper. Indeed, as the court observed, that was the avowed purpose of the cancellations. In short, taxpayer employed a device for transforming its creditor relationship into a stockholder relationship, thereby permitting the debtor corporations' capi-

tal structures to be strengthened and enabling them to continue in business, to the obvious benfit of the taxpayer, as stockholder. Such a voluntary shift in relationship does not result in any kind of present loss to the taxpayer.

The recent decision of the Sixth Circuit in *Bratton* v. *Commissioner, supra,* is fully in accord with the decision below. There, the taxpayer, in order to persuade one Judd to take over the active management of a corporation, voluntarily agreed to release the corporation from claims for sums previously advanced. At the same time, taxpayer sought to deduct relinquished claims as a bad debt. The Sixth Circuit decided the case upon the precise ground relied on by the court below, namely, that the taxpayer's voluntary relinquishment of his claim against the corporation converted the debt into a capital contribution and removed any right he might have had to assert a bad debt deduction.

The fact that, under the holding below, a stockholder is denied a bad debt deduction does not, of course, deprive the taxpayer of all tax benefit, for, as the court below observed, the cancellation of the debt will be reflected in the basis of the stock received and consequently, if any loss is ultimately sustained, it will be realized when the stock is disposed of or becomes worthless. See also *Estate of Mallory* v. *Commissioner,* 27 B. T. A. 750. Of course, where, as here, the corporations are enabled to continue in existence

and prosper as a consequence of the debt cancellation there may be no ultimate loss to the stockholder on his stock investment. But this only emphasizes the propriety of denying a loss deduction when the debt is transformed into an additional stock investment.

As to the second contention, the court below recognized that, with the exception of the *Bratton* and the *Olds* cases, *supra,* the Regulations and authorities cited above were concerned with the question whether the debtor received taxable income by reason of the cancellation of an indebtedness. It concluded, however, that this "alleged distinction" was irrelevant, pointing out that if the debtor received a contribution to its capital the creditor must have made the contribution and that consistency required that both parties treat it alike. (Pet. 14.) Obviously, this is so. If a particular transaction constitutes a capital contribution and is therefore excluded from a corporation's income, it would be extraordinary to say that the same transaction should be classified as something else in determining whether the stockholder is entitled to a deduction.

2. Contrary to the assertion of taxpayer (Pet. 4–5), there is no necessary or irreconcilable conflict between the decision below and *Giblin* v. *Commissioner,* 227 F. 2d 692 (C. A. 5th). While the views of the Second and the Fifth Circuits on the ultimate question presented may not be entirely harmonious, nevertheless, as the court be-

low pointed out in its opinion (Pet. 13), whether a particular transaction results in a capital contribution depends largely upon the intent of the parties as shown by individual circumstances. In the instant case, the Tax Court found as an ultimate fact (Pet. 23) that taxpayer made a capital contribution to its subsidiaries in the amount of the debts canceled. The Court of Appeals concluded (Pet. 15) that taxpayer "intended" to do so, as evidenced not only by its receipt of stock in exchange for the cancellation, but also by book entries which treat the transactions as capital contributions. Undoubtedly, the court had these factors in mind when it said that the *Giblin* case "may be distinguishable on the facts." (Pet. 15.)

Although the findings of the Tax Court in *Giblin* v. *Commissioner,* decided October 29, 1954 (1954 P-H T. C. Memorandum Decisions, par. 54, 292), show that the debtor corporation there involved made entries treating the cancellation of the creditor's claims as a capital contribution, the Tax Court gave no weight to that fact. It decided the case on the assumption that the advances constituted loans rather than contributions to capital, and it held that since the taxpayer was not engaged in the business of making loans to corporations the advances were not in any event deductible as business bad debts under Section 23 (k) (1). On review of the Tax Court's *Giblin* decision, the Fifth Circuit was

not confronted with any ultimate finding of fact, such as made in the instant case, that the taxpayer, when it forgave the obligations, intended to make a capital contribution. Thus, the Fifth Circuit did not have the benefit of any discussion of that matter by the Tax Court. Indeed, the Court of Appeals thought it significant that (p. 699) "the Tax Court declined to base its decision on the theory advanced by the government." Moreover, the taxpayer there did not receive any shares of stock in exchange for the cancellation of the advances made, as did the taxpayer in the present case.

Because of these differences between the cases and because of the strong possibility that the Fifth Circuit, if it were to pass on a factual situation identical with that presented here, might reach the same conclusion as the court below, the Government refrained from filing a petition for a writ of certiorari in the *Giblin* case. By the same token, we believe that there is no conflict of the kind which would warrant a grant of certiorari in the instant case.

CONCLUSION

For the reasons stated, it is respectfully submitted that the petition for a writ of certiorari should be denied.

Respectfully submitted.

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